Russia And The Opposite Of Bankruptcy

A number of years ago I was in a real panic about something, what I cannot even recall now, and as I spelled out the disaster scenario a friend interjected, "…and then?" I could not complete the "and then?" to any further calamity and realized the wisdom: Whenever someone spells out a disaster, you should ask, "and then?" Especially if that someone is Treasury Secretary Geithner, present at the creation of much mischief since 2008, speaking about the debt ceiling.

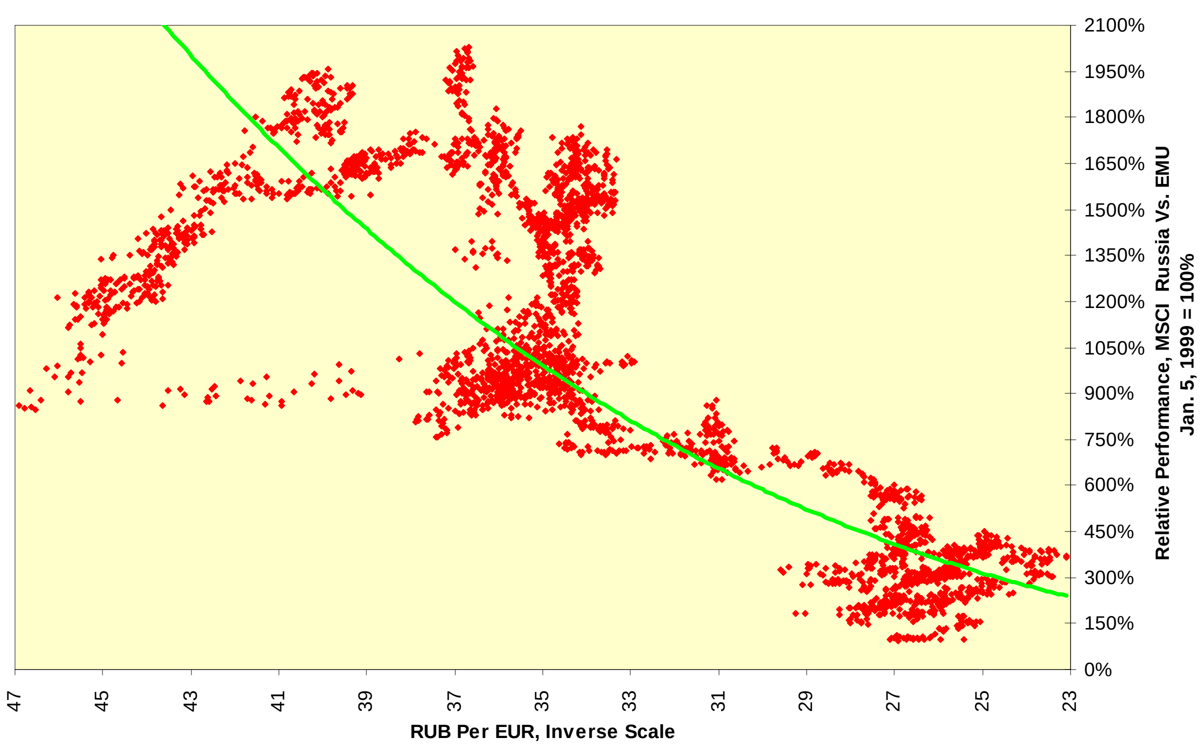
Our good friends in Russia had such a moment in August 1998: They defaulted on their sovereign debt, their leader was a booze-hound from the word "go," the country was being looted by oligarchs, the former empire was gone, their equivalent of Treasury bills had soared to 240% or some other meaningless number, the prices of their major commodity exports were collapsing to 200-year lows and some were worried bad things were about to happen.

Well, I stuck around St. Petersburg, when I saw it was time for a change: Thirteen years later Russia's foreign exchange reserves have soared to $465 billion, almost 30% of their GDP, and their big problem is managing domestic inflation. Moscow is one of the most expensive cities in the world, filled with men of wealth and taste and steeped in a culture where tangible assets are preferable to paper any time. Just look at neighboring Belarus, the former Byelorussian Soviet Socialist Republic, whose own ruble just collapsed to the point where toasters and canned goods have taken on monetary value.

Crude Oil And Currency Connections

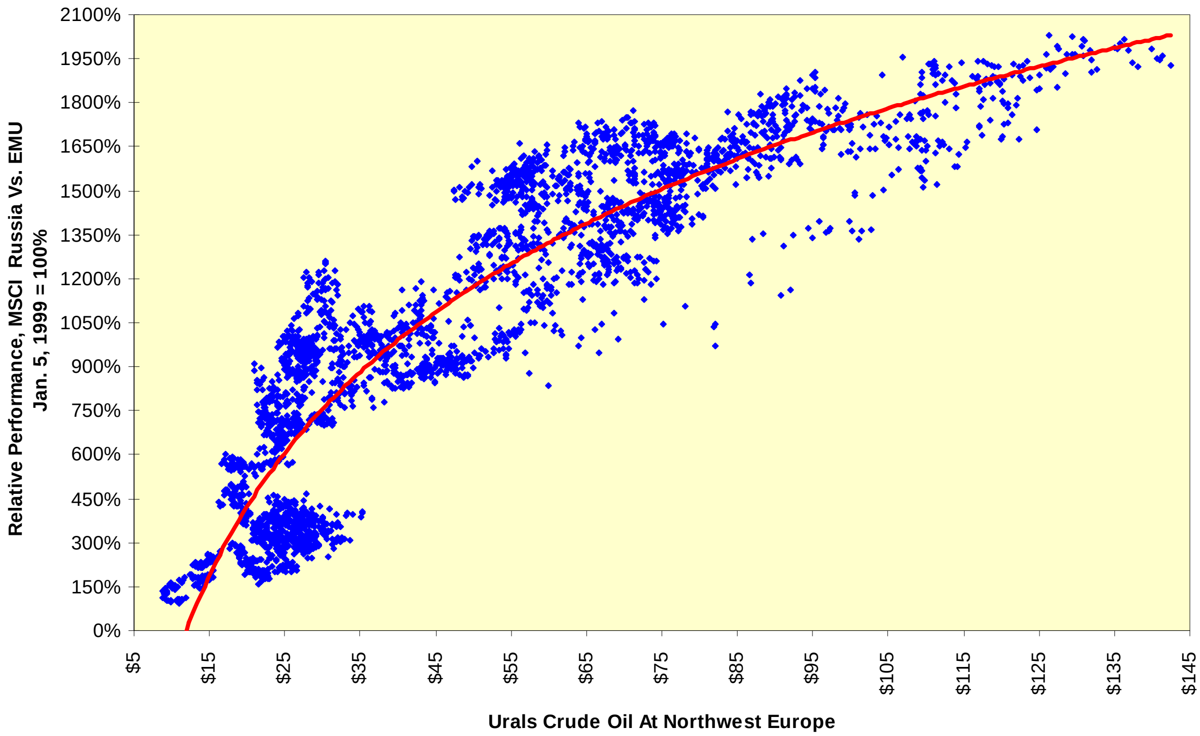
The Central Bank of Russia has increased its refinancing rate twice in 2011; it now stands at 8.25%. This has helped strengthen the RUB against both the dollar and the euro. The excess carry returns for borrowing the USD and EUR and lending into the RUB have exceeded 9% and 3%, respectively, year-to-date. As noted yesterday in the case of Mexico, the relative performance of Russian stocks relative to the MSCI Eurozone basket declines as the RUB strengthens against the EUR. Higher short-term interest rates in Russia are likely to worsen their stock market's relative performance.

Russian Equity Relative Performance And RUB/EUR Cross-Rate



A second determinant of relative Russian performance, once again using the Eurozone as a basis for comparison, has been crude oil prices. The relative performance of Russian stocks rises as a logarithmic function of the price of their benchmark Urals crude oil exports to refining centers in Northwest Europe.

Russian Equity Relative Performance A Function Of Crude Oil



As the long-term trend for crude oil prices remains higher for the foreseeable future, this will tend to offset the effects of a stronger ruble somewhat. However, the large cash flows from the exports of crude oil and other resources will increase inflationary pressures and force both short-term interest rates and the ruble higher.

Russia lived through a period when money was scarce and emerged stronger from the experience. They now are living in a period where money is too abundant and are fighting its effects. I suspect cash will burn a hole in their pockets and the end result will be underperformance from Russian equities.